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"Corporate governance deficiencies in the regulation and disclosure of director remuneration in the South African context of Mergers and Acquisitions"

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I hereby declare that I have read and understood the regulations governing the LLM dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

A. INTRODUCTION

Corporate governance has for a long time been a controversial subject and this controversy is glaringly evident in the determination and disclosure of director remuneration. One of the first times the controversy of director remuneration reared its head was during the financial crisis of 2008 which was described as the biggest financial crisis since the Great Depression of the 1930's[1]. The Organisation for Economic Co-operation and Development (OECD)[2] and the United Nations body United Nations Conference on Trade and Development (UNCTAD)[3] both cited failures in corporate governance, the practices of director remuneration and inadequate regulation and control thereof, as specific causes of the financial crises of 2008. The reason for this is that remuneration systems employed by companies failed to sufficiently align remuneration packages of directors with the strategy, risk appetite and long-terms interests of the company and shareholders.[4] The controversy arose when even though many companies failed or showed great losses, directors were still paid out excessive bonuses and were considered to be rewarded for failure.[5] This controversy was caused by the failure of corporate governance systems to effectively regulate and enforce company remuneration practices, the adequate disclosure of information regarding director remuneration, and the lack of shareholder input in the determination of director remuneration and bonuses. In addition is the fact that most corporate governance systems are based on a 'comply or explain' or 'apply or explain' approach which, despite its advantages, renders the application of corporate governance structures voluntary, or at a minimum, non-compliance could be explained away.

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[1] Adrian Blundell-Wignall, Paul Atkinson, Se Hoon Lee *The Current Financial Crisis: Causes and Policy Issues* (2008) Financial Market Trends, OECD Publication. Page 2. Available online from: http://www.oecd.org/dataoecd/47/26/41942872.pdf (accessed 8 June 2014).
[2] Adrian Blundell-Wignall et al (2008) Page 11.
[3] United Nations Conference on Trade and Development *UNTACD Report: Corporate Governance in the Wake of the Financial Crisis: Selected International Views* (2010) Page 17. Retrieved online from: http://www.unctad-docs.org/files/CG-in-Wake-of-Fin-Crisis-Full-Report.pdf (Accessed 8 June 2014)
[4] David Larcker & Brian Tayan *Corporate Governance Matters: A Closer Look at Organizational Choices and their Consequences* (2011) Page 197.
[5] Naveen Kumar & J. P. Singh *Global Financial Crisis: Corporate Governance Failures and Lessons* (2013) *Journal of Finance, Accounting and Management.* Vol. 4, No. 1. Page 5.

This dissertation examines a weakness in the corporate governance structures of South Africa regarding the disclosure director remuneration in the context of mergers and acquisitions. The submission is that directors act in their own interests; that they benefit more from mergers and acquisitions than the company and its shareholders *vis-à-vis* short and long term incentives, contrary to the fiduciary duty owed to the latter; and posits that the current corporate governance system in South Africa, its disclosure requirements, and its application are insufficient.

The first section of this dissertation briefly describes the history of corporate governance in South Africa from the first King Code of 1994 to its most recent rendition, the King III Code. It includes a discussion of the reasons advanced for its existence, its theoretical underpinnings, and its method of application being the ‘apply or explain’ approach.

The second section discusses director remuneration. It discusses the agency problem which is the theoretical basis for the problem under discussion.

The third section discusses the development of the remuneration committee in South Africa through the King Codes including the developed terms of reference, recommended structure of remuneration packages, and finally the disclosure requirements.

The fourth section discusses mergers and acquisitions, providing a definition, reasons why companies engage in mergers and acquisitions, and providing the most common reasons for the failure thereof.

The fifth section discusses event studies which necessitates an economic examination as to the effects of mergers and acquisitions on the share prices of the companies engaging in such activities. A comparison of the findings of local studies is made to international studies to illustrate that the findings are not a remote or local phenomenon but an international and well documented finding which corporate governance measures have seemed to ignore, or at the very least failed to address sufficiently.

Finally, a summation follows and recommendations are made to strengthen the corporate governance structures to mitigate the excessive benefits accruing to directors and align South Africa’s corporate governance structures with international trends.

1. Brief history of corporate governance in South Africa

During the early nineteen nineties South African corporations where isolated from the international economy and characterized by poor corporate governance owing to the apartheid regime and the prevalence of family owned companies.[6] As a result of the political isolation, corporate practices, rules, norms and legislation fell behind and where outdated.[7] Since the country obtained independence in 1994, the country had been re-insinuated into the world economy and was forced to transform its commercial environment to keep abreast with international trends and attract foreign investment. South Africa joined the World Trade Organisation on 1 January 1995[8] and implemented various mechanisms to improve corporate governance, including legislation such as the Insider Trading Act no. 153 of 1998, publication of the voluntary King Report followed by two more publications of the King Report which eventually became a listing requirement for the JSE and the AltX, and the enactment of the Companies Act 71 of 2008.

The first King Report was released in 1994 and was the product of committee convened by the Institute of Directors chaired by Mervyn King[9] and had as its purpose the publication of a code of corporate governance, practice and conduct. The underlying aim of the Code was to improve corporate governance with a view to achieving a single bottom line: maximization of profits for shareholders.[10] The code was to incorporate international trends and best practice, drawing extensively from the United Kingdom's Cadbury Report[11], whilst having regard to the South African context and the underlying value of shareholder primacy. Various task groups were formed to consider different aspects of corporate governance such as stakeholder communication, executive responsibility regarding the frequency, substance and form of information to shareholders.[12] There was a focus in the King Report, as with the Cadbury Report, on disclosure of information to shareholders to enable them to oversee the board of a

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[6] Stephen Malherbe, *Corporate Governance in South Africa* (Trade and Industrial Policy Strategies, 2001) page 2.
[7] Stephen Malherbe, page 2.
[8] www.wto.org, accessed 9 July 2014.
[9] Stephen Malherbe, page 56.
[10] Stephen Malherbe, page 2.
[11] Stephen Malherbe, page 57.
[12] Stephen Malherbe, page 57.

company through exercising their votes.[13] The Report also provided for the creation of certain committees such as audit and importantly, remuneration committees.[14] The downfall of the Report was that it was essentially voluntary and were at the crux mere recommendations which were put to companies but could be explained away in annual reports which, it was submitted, was never or rarely done to begin with.[15] Similarly to international conventions, the King Report of 1994 was a form of "soft law" which had no teeth and could be ignored. Although the King Report of 1994 had its disadvantages, it did make an important contribution, as stated in the King Report of 2002, in that it "formalized the need for companies to recognize that they no longer act independently from the societies and the environment in which they operate".[16] It created public awareness as to the issues surrounding corporate governance and alerted companies and the broader stakeholders that companies are not creatures that operate in isolation but that their actions and conduct have consequences that not only affect the company itself and its shareholders but the whole society and environment in which it operates.

The King Committee was reconvened in 2000 to revise and update the King Report of 1994 according to new prevailing international trends and to stay abreast of the changes that occurred internationally, given the emerging markets crisis in the latter part of the 1990's. During this period, a number of significant legislative steps had been taken to improve and strengthen corporate governance in South Africa. Amoung the legislative enactments were; the Labour Relations Act (1995), the Basic Conditions of Employment Act (1997), Employment Equity Act (1998), the National Environmental Management Act (1998), the updated JSE listing requirements, various amendments to the Companies Act (1973), and various updates and new acts regulating corporate governance of public and government institutions.[17] What these legislative actions indicated was a real and serious commitment to align South Africa's corporate practices to international best practice and hinted towards the inevitable philosophical direction in which corporate governance was heading, being a broader stakeholder inclusive model

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[13] Stephen Malherbe, page 58.
[14] Stephen Malherbe, page 58.
[15] Stephen Malherbe, page 59.
[16] King Committee, *King Report on Corporate Governance for South Africa* (Institute of Directors, 2002). Page 7.
[17] King Committee (2009), page 9.

as opposed to a value-for-shareholder based approach to corporate governance. The King II report acknowledged that there was a worldwide shift towards the 'triple bottom line' which incorporated economic, environmental, and social aspects of a company's activities.[18] In the introduction to the King Report of 2002, seven characteristics of good corporate governance were enumerated according to international best practice and emerging trends which were Discipline, Transparency, Independence, Accountability, Responsibility, Fairness, and Social Responsibility. The most relevant characteristics for the purposes of this dissertation will be described briefly below.

The first characteristic was 'Discipline' which meant a commitment by senior management to 'adhere to behavior that is universally recognized and accepted to be correct and proper'.[19] This, along with the characteristic of Social Responsibility, signaled the importance and introduction of the concepts of corporate citizenry and an 'inclusive model' to corporate governance. Secondly, was the characteristic of 'transparency' which was aimed at not only a disclosure of economic aspects of the company, but also non-financial aspects of the company. The Report recommended reporting on issues 'associated with social and ethical accounting, auditing and reporting, and safety, health and the environment'.[20] The purpose of such transparent reporting was described in the Report as 'a measure of how good management is at making necessary information available in a candid, accurate and timely manner…including general reports and press releases'.[21] The underlying purpose was to enable 'investors to obtain a true picture of what is happening inside the company'.[22] These to characteristics also formed part of the back-bone to the guiding principles for the review of the 1994 King Report.[23]

The Draft Code of Governance Principles for South Africa was issued in February 2009,[24] with the final Code being published in September of the same year, in

[18] King Committee (2002), page 10.
[19] King Committee (2002), page 11.
[20] King Committee (2002), page 16
[21] King Committee (2002), page 12.
[22] King Committee (2002), page 12.
[23] King Committee (2002), page 16.
[24] Institute of Directors in Southern Africa, *The Draft Code of Governance Principles for South Africa* (2009) page 1.

anticipation of the then new Companies Act of 2008, which was to enter into operation in 2010,[25] and changes in international corporate governance, developments and trends.[26] The King III Code's underlying philosophy revolved around issues of leadership, corporate citizenship and sustainability.[27] The key conceptual drivers behind the Code was firstly, the 'Triple Context' within which companies operate, being the social, environmental, and economic contexts.[28] A second driver was that of Sustainability,[29] not only in terms of the environmental aspect, but also economic aspect was emphasized. As international trends and findings suggest, the economic success of a company is inextricably linked to issues of sustainability in the environmental context, and a more philosophical concept of the word, such as being more conscious of the long-term longevity of the company as opposed to chasing short-term gain, assessing strategy and risk with a view to longevity, and even gearing remuneration packages to motivate long-term sustainable performance. Sustainability was to inform all conduct and policies of the company, for its own benefit and also the benefit of the broader stakeholder, adopting a 'stakeholder inclusive approach'.[30] This 'stakeholder inclusive' approach was the third driver of the Code. This approach meant that all stakeholders in a company, to put it simply, being anyone affected by the actions of the company such as the environment, the community in which it operates, employees etc. should be considered within the context of the best interests of the company.[31] This meant that the shareholders no longer formed the primary concern of the company and are essentially included as a stakeholder to be considered when determining a course of action in the best interests of the company. This gave effect to the concept of companies being corporate citizens having lasting positive effects for all stakeholders.[32] The third conceptual driver the Code placed emphasis on was Integrated Reporting which meant that the company was no longer required to merely report on financial data which is considered to be a photograph of the company's financial position at a particular point in

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[25] The Companies Act 71 of 2008
[26] Institute of Directors in Southern Africa – The Draft Code (2009) page 6.
[27] Institute of Directors in Southern Africa – The Draft Code (2009) page 10.
[28] Institute of Directors in Southern Africa – The Draft Code (2009) page 12.
[29] Institute of Directors in Southern Africa – The Draft Code (2009) page 12.
[30] Institute of Directors in Southern Africa – The Draft Code (2009) page 12.
[31] Institute of Directors in Southern Africa – The Draft Code (2009) page 13.
[32] Institute of Directors in Southern Africa – The Draft Code (2009) page 13.

time[33] but other aspects described as Environmental, Social, and Governance issues (ESG)[34] which provides the potential investor and stakeholder with insight into a company which a balance sheet or profit and loss statement could not provide. It has the advantage of improving risk management, increasing business opportunities, instilling external trust and confidence in the directors, and enhancing the company's transparency, goodwill, and reputation.[35] It enables a company to disclose the positive and negative impacts it has had on society and provide a platform for the company to report on how it intends to mitigate the negatives and improve or sustain the positives,[36] and finally provides a written statement to which shareholders can hold the directors of a company accountable to.

Finally, the last major conceptual driver of the Code is that of the compliance approach adopted, being an 'apply or explain' approach, as opposed to the 'comply or explain' approach adopted in the King Code of 2002. Compliance with corporate governance frameworks has always been a point of contention in that where mere recommendations are made, the force and effect of the framework can be easily vitiated or evaded, but on the other hand a compulsory legislated system becomes inflexible as corporate governance is a liquid concept constantly changing, and no one set of rules can apply to all companies thus making compliance costly and often irrelevant to a specific business.[37] The main international example of a country adopting a legislated corporate governance framework is the United States of America with its Sarbanes-Oxley Act.[38] This type of regime is commonly referred to as a 'comply or else' approach[39] which carries with it legal sanctions for non-compliance. In its arguments against adopting such an approach, the committee referenced the cost of compliance of a specific section in the Act at $264 billion [40] and total compliance with the Act of approximately

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33 Institute of Directors in Southern Africa – The Draft Code (2009) page 13.
34 Institute of Directors in Southern Africa – The Draft Code (2009) page 13.
35 Institute of Directors in Southern Africa – The Draft Code (2009) page 13.
36 Institute of Directors in Southern Africa – The Draft Code (2009) page 13.
37 Institute of Directors in Southern Africa – The Draft Code (2009) page 5.
38 Institute of Directors in Southern Africa – The Draft Code (2009) page 6.
39 Institute of Directors in Southern Africa – The Draft Code (2009) page 6.
40 Institute of Directors in Southern Africa, *The Draft Code of Governance Principles for South Africa* (2009) page 7.

the combined debt write-off of Enron, World Com, and Tyco.[41] The King Committee further opined that having one framework to apply to all companies was logically impossible as businesses vary from one another to such a large degree,[42] in the their industrial requirements, the types of business operations, their specific needs and requirements, business drivers, and what each company needs to focus on at a particular point in time. Therefore, what may be applicable to one company may be totally irrelevant to another, however the latter must expend time and money to ensure compliance or face legal sanction.

The other approach to compliance is a voluntary approach which is followed by South Africa, the United Kingdom with its UK Corporate Governance Code of 2012[43] and various European Union member states[44]. This voluntary approach is referred to as the 'comply or explain' approach as opposed to 'comply or else'.[45] Although the application of the Code is voluntary, many of the recommendations put forward in the King Code of 2002 had been legislated into the Companies Act of 2008. Additionally the adoption of the King Code is a requirement for companies intending to list on the Johannesburg Stock Exchange (JSE) and the AltX which is a division of the JSE aimed at providing a trading platform for 'small and medium-sized high-growth companies'.[46] These measures give the Code more force and effect especially regarding the larger companies that are listed on the JSE or AltX or those companies intending to list.

The 'comply or explain' evolved into further different approaches. For example when the United Nations Conference on Trade and Development had to decide whether their corporate governance code entitled, 'Guidance on Good Practices in Corporate Governance Disclosure'[47] should be on the 'comply or else', 'comply or explain', 'apply or explain', or 'adopt or explain' basis they decided in favour of the latter.[48] South Africa adopted the 'apply or explain' approach as it was thought that this approach was more

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[41] Institute of Directors in Southern Africa (2009) page 6.
[42] Institute of Directors in Southern Africa (2009) page 6.
[43] https://www.frc.org.uk. (19 July 2014).
[44] Institute of Directors in Southern Africa (2009) page 6.
[45] Institute of Directors in Southern Africa (2009) page 6.
[46] https://www.jse.co.za/capital/altx. (3 July 2014).
[47] United Nations Conference on Trade and Development, *Guidance on Good Practices in Corporate Governance Disclosure*, United Nations (2006)
[48] Institute of Directors in Southern Africa (2009) page 7.

in line with the spirit and object of the King Code in that the directors of companies would have to apply their minds to the principles and recommendations to determine its relevance to the company rather than a 'check-the-box' approach to complying to principles.[49] It allows the directors of company a certain degree of flexibility in that instead of mindlessly complying with a recommendation, the board could follow a principle and apply it differently to still achieve the result.[50] To use a rudimentary illustrative example, a recommendation with purpose of achieving gender equality could be to hire an equal number of men and women. A company could 'check the box' and hire an equal number of male and female employees, but remunerate the males more advantageously although still complying with the letter of the recommendation. Whereas if the underlying principle of gender equality were applied, the company could, even though there are more male employees (for example because of operational requirements) remunerate female employees equally for equal work, or have a policy of considering females first for promotion to management positions. In the latter instance the underlying objective of gender equality is achieved, although not the numerical objective and requires more active and considered thought by directors as the aim of a recommendation. In essence, the difference between 'comply or explain' and 'apply or explain' is that of substance over form.

2. Director's Remuneration

Director's remuneration has long since been a controversial issue both locally and internationally. Director remuneration has gained a great deal more attention and scrutiny since the global financial crisis of 2008 where many large companies failed but directors and managers of failed companies were still paid substantial bonuses and seen to be rewarded for failure.[51] The Australian Government Productivity Commission pointed in 2009 that 'internationally, various forums have identified remuneration practices as a contributing factor to the global financial crisis. Strong growth in executive

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[49] Institute of Directors in Southern Africa (2009) page 7.
[50] Institute of Directors in Southern Africa (2009) page 7.
[51] Naveen Kumar & J. P. Singh *Global Financial Crisis: Corporate Governance Failures and Lessons* (2013) *Journal of Finance, Accounting and Management.* Vol. 4, No. 1. Page 25

remuneration from 1990s to 2007, and instances of large payments despite poor company performance, have fuelled community concerns that executive remuneration is out of control.'[52] Former minister of finance, Trevor Manuel, intimated similar opinions in an interview with the Financial Mail when he stated that the Government was concerned about excessive remuneration in relation to poor performance of executives and stated that some of the salaries were 'unjustified' and even 'repulsive' in the context of South Africa's high unemployment and inequality.[53]

Companies have been in existence for centuries, but it is submitted that it was only with the establishment of public companies and the first stock exchange in 1856 when a different breed of manager became necessary to advance the interests of shareholders.[54] Although the precise legal relationship between the director and the company is subject to debate, it is submitted that the most appropriate defining relationship is that of Agency.[55] In terms of Agency, directors or managers act as agents for the shareholders as their principals. Such a relationship comes into being when one person, the principal, hires another, the agent, to represent his or her interests[56] which is analogous to the director-shareholder relationship. In such a relationship a possibility arises that a conflict of interest between the principal and agent arises; this problem is known as the 'agency problem'.[57] Essentially this conflict of interest boils down to the agent acting in a self-interested manner pursuing his own interests, as opposed to acting in the interests of the shareholder principals. This conflict of interest carries with it a cost to the company referred to as 'agency cost'.[58] Agency costs can be indirect or direct with an example of the former being where management declines to exploit an opportunity causing a loss of opportunity.[59] The latter takes two forms; the first being

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[52] Australian Government Productivity Commission *Executive Remuneration in Australia* (2009) *Inquiry Report* No. 49, 19 December 2009.
[53] Financial Mail. *Executive Pay – Is Intervention Required?* 2 August 2008. http://www.leader.co.za/article.aspx?s=1&f=1&a=825 (accessed 11 August 2014)
[54]H.E. Scholtz & A. Smit *Executive Remuneration and Company Performance for South African Companies List on the Alternative Exchange (AltX)* (2012) *Southern African Business Review.* Vol. 16, No. 1. Page 22.
[55] F. Cassim (2012) pages 411 - 414.
[56] Stephen A. Ross et al *Corporate Finance 10ed* (2013) page 13.
[57] Stephen A. Ross et al (2013) page 13.
[58] Stephen A. Ross et al (2013) page 14.
[59] Stephen A. Ross et al (2013) page 14.

direct corporate expenditure that benefits management but not the shareholders such as performance bonuses and fringe benefits.[60] The second form results from expenses incurred in monitoring the actions of management such as payment of independent auditors[61] and the cost of compliance with King III corporate governance measures. The remedy recommended to alleviate this agency cost is through the remuneration package of the agent by granting share options and similar performance based incentives to align the interests of the agent with those of the shareholder by granting the agent ownership in the company.[62]

In contemporary South African commerce and indeed internationally, the task of deciding director remuneration theoretically falls to the Remuneration or Compensation Committees. These committees are tasked with devising a remuneration policy which puts forward recommendations to the board the company as to how to remunerate its directors and executives fairly and responsibly, and to assist the board in making accurate, complete and transparent disclosure of remuneration practices.[63] Factors taken into consideration when determining the remuneration of directors or executives include the size of the company,[64] the need to attract skilled and knowledgeable candidates with the requisite expertise, the need to retain existing management and potential management through long term incentives, comparative trends in remuneration, acceptability of the remuneration package to shareholders, and the short and long-term goals of the company amoung others.[65]

Remuneration packages typically consist of fees paid for services rendered by directors, monthly salary, bonuses, performance-related payments, expense allowances,

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[60] Stephen A. Ross et al (2013) page 14.

[61] Stephen A. Ross et al (2013) page 14.

[62] H.E. Scholtz (2012) Page 25.

[63] Institute of Directors *King III Chapter 2 Practice Notes: Remuneration Committee Terms of* Reference (2009) Page 2.

[64] Paul Guest *The Impact of Mergers and Acquisitions on Executive Pay in the United Kingdom* (2007) University of Cambridge Centre for Business Research, *Working Paper No. 354.* Page 1; Sourafel Girma, Steve Thompson & Peter Wright *Merger Activity and Executive Pay* (2002) Research Paper 2002/02 *Globalisation and Labour Markets Programme*, University of Nottingham.

[65] Dr. Philip Theunissen *Remuneration and Benefits Review of State Owned Enterprises* (2010) page 3.

contributions to any pension or retirement scheme, the value of any option or right granted to a director in respect of share of a company, or any financial assistance.[66]

Bonus payments are usually cash payments linked to short term targets.[67] Examples of performance indicators are; number of units sold, number of units produced, cost of production per unit, profit per annum, market share etc. the list is endless and is geared for each business's financial needs and requirements. The payment of rewards in terms of the achievement short term targets are usually assessed and reviewed annually.[68] Long term incentives, on the other hand, are usually share-based awards.[69] The purpose of this threefold. Firstly, to align the interests of directors to those of the shareholder, mitigating the agency problem outlined above. Secondly, to retain the director as the bonuses usually accrue and vest in the director after a specific number of years[70]. And finally, to motivate the director to strive to create actual shareholder value, as the awards are usually linked to the performance of the shares.

The most commonly used long term incentive takes the form of share options. Share options granted under company share option schemes as a reward for achieving certain long term targets, both financial and non-financial.[71] A share option is an option or right granted to its holder to purchase shares at a pre-determined price, referred to as the strike price. The holder is not obliged to exercise the option and if not exercised within the specific time period, the option will lapse. As an example, a director may be granted 100 000 share options at a strike price of R50.00 per share (to a total value of R5 million) which is the current market price per share. The option is exercisable from three years from the date of the grant and is valid for a period of two years thereafter. Upon the arrival of the option grant date, the market value of the shares is R70.00 (to a total value of R7 million), however the director is entitled to purchase the shares at R50.00. The director can exercise his option to purchase and sell the shares immediately and make a personal profit of R2 million. The director can finance the purchase himself or

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66 Companies Act No. 71 of 2008, Section 30(6).
67 The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 157.1 (ii).
68 The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 158.3.
69 The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 157.1 (iii).
70 The Institute of Directors of Southern Africa – The Report (2009) Practice Recommendation 168.
71 The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 154.1

obtain short-term financing from the company and repay it with the profits.[72]The use of share options has the effect of imputing a personal interest to the director thereby motivating the director to maximize the increase in the share price thereby creating shareholder value and creating profit and value for himself.

The danger in granting awards based on performance, both long and short term, is that they often overlap. The King Code does warn against this[73] however, as will be illustrated in due course, this is an increasingly difficult task in the context of mergers and acquisitions, and the provisions regarding disclosure are insufficient and do not provide enough guidance to prevent directors from acquiring unearned benefits.

3. Development of the Remuneration Committee

One of the fundamental issues regarding the remuneration of directors and executive directors is who determines the remuneration package. In the past, the directors determined their own remuneration, which is obviously not sound from a corporate governance perspective nor from a business perspective as it would clearly be open to easy abuse. Examples of the abuse to which such a system can be subjected to are the Regal Treasury Private Bank[74] scandal in 2001 where the South African Commission of Enquiry discovered that the Chairman of the Board authorised the granting of a cash bonus of R2 Million, a tax-free dividend of R650 000.00 and shares to the value of R17 Million in lieu of a restraint of trade agreement, all without Board approval to the CEO who incidentally was also his brother-in-law.[75] Further afield, the ENRON scandal, a US Senate sub-committee exposed, *inter alia*, that in one financial year, bonuses of U$750 million was paid to senior executives whereas the net income of the group for the same period amounted to only U$975 million.[76] In South Africa, the King Report of 2002

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[72] Companies Act No. 71 of 2008, Section 30(6)(f)
[73] The Institute of Directors of Southern Africa – The Report (2009) Practice Recommendation 160.
[74] Adv JF Myburgh SC *Report of the Commissioner in terms of S69A (11) of the Banks Act 94 or 1990 – Regal Treasury Private Bank Ltd (in curatorship)*, South African Reserve Bank, 15 November 2001. Page 1.
[75] Adv JF Myburgh SC *Report of the Commissioner in terms of S69A (11) of the Banks Act 94 or 1990 – Regal Treasury Private Bank Ltd (in curatorship)*, South African Reserve Bank, 15 November 2001.
[76] D. Ackman, *Pay and Madness at Enron*, 22 March 2002, available at *http://www.forbes.com/2002/03/22/0322enronpay.html*, accessed on 12 August 2014

recommended that remuneration matters should be considered by a remuneration committee which makes recommendations to the board of directors, this was supplement and refined by the King III Report and further augmented by the King III Practice Note of 2012.

What follows is a more comprehensive discussion of what a remuneration committee is, its functions, its constitution, and their terms of reference in terms of the aforementioned codes and reports and specifically of the King III Practice Note of October 2012.

The King Code of 2002 did not provide for the formation of a remuneration committee *per se*, instead it uses the following phrase in article 2.5.2 of the code that 'companies *should* appoint a remuneration committee or such other appropriate board committee'.[77] The wording of this phrase is clearly not peremptory, however it goes on to state that whatever committee does determine the remuneration of directors should consist of 'entirely or mainly of independent non-executive directors, to make recommendations to the board within the agreed terms of reference on the company's framework of executive remuneration packages for each of executive directors'.[78] This latter requirement laid the foundations for the requirements for remuneration committees in the Code of 2009. Although the Code of 2002 does not specifically recommend the creation of a remuneration committee, it does provide model terms of reference for the ideal board committees in Appendix V of the King Report.[79] The committee provides a caveat and states the terms of reference provided are merely recommendations to provide guidance for companies intending to form such committees and that it is up to the board to define and develop the terms necessary for the company to meet its own unique requirements.[80]

In the Appendix to the Code of 2002 it is recommended that 'every company should establish a formal and transparent procedure for developing a policy on executive remuneration and for fixing the remuneration packages of individual directors, within

[77] King Committee, *King Report on Corporate Governance for South Africa* (Institute of Directors, 2002). Article Page 26.
[78] King Committee (2002). Page 26.
[79] King Committee (2002). Page 182.
[80] King Committee (2002). Page 182.

agreed terms of reference, to avoid potential conflicts of interest.'[81] It recommends that the committee be constituted solely or substantially of non-executive directors who are to make use of independent surveys and consultants to determine remuneration packages which satisfy shareholders as to reasonableness and attract directors of sufficient caliber to help the company prosper.[82] The remuneration committee was recommended to consist of not less than three directors appointed by the board of directors of whom all should be independent non-executive directors.[83] They should additionally appoint a chairperson for the remuneration committee and that the chairperson of the board would be eligible if they were also an independent non-executive director.[84] The terms of reference were to determine, agree and develop a policy on executive and senior remuneration for specific directors of the company and included determining basic salary, benefits, bonuses, performance based incentives, share incentives, pensions benefits and the like, and also to determine the criteria and standards to measure performance of directors.[85] In determining the remuneration package for executive directors, the aim and structure of the package should be to motivate the directors to enhance the company's performance and simultaneously ensure that the directors are reasonably, fairly, and responsibly rewarded for their performance.[86] The committee was recommended to co-ordinate with the chairperson of the board and the chief executive in determining remuneration packages and the company's remuneration policy.[87] As regards the actual remuneration and types of remuneration, the forms of payment suggested were cash as base salary, and shares or share options to align the interests of the directors with those of the shareholders[88] to mitigate the agency problem as mentioned earlier. Supplementary fees for work resulting from membership of other board committees was allowed provided they are charged separately. The committee was tasked to make recommendations on the

[81] King Committee (2002). Page 194.
[82] King Committee (2002). Page 194.
[83] King Committee 2002). Page 194.
[84] King Committee (2002). Page 194.
[85] King Committee (2002). Page 195.
[86] King Committee (2002). Page 195.
[87] King Committee (2002). Page 195.
[88] King Committee (2002). Page 195.

payment of other benefits such as pension fund contributions, retirement benefits and severance payments.[89]

Under the Code of 2002 no shareholder input was required and the only recommendation was that a company can disclose the remuneration of directors and its remuneration policy in the annual report. One must bear in mind that the creation of a remuneration committee was voluntary, the structure, constitution and terms of reference were provided for in the appendix to code, which spoke to the lax approach or non-peremptory nature of the formation of such committee, that the recommendations and guidance regarding the actual forms of remuneration was very sparse, shareholder approval was not required, and finally that disclosure was not necessarily a requirement and dependent on whether the company *chose* to form such a voluntary committee. From this one can ascertain that under the Code of 2002, principles regarding remuneration and disclosure were still ill-developed although it was an aspect of serious concern in corporate governance internationally as can be seen in the examples of abuse of remuneration of directors mentioned earlier.

Under the current and third rendition of the King Code the provisions dealing with the formation of a remuneration committee remained non-peremptory as in King II.[90] The recommendation for the composition of the committee has also remained the same in that it states that the board committees should be composed of a majority of non-executive independent directors[91] as per the King Report and is supplemented by the Practice Note in adding that executive directors should only attend meetings on invitation[92]. However, a great deal more emphasis was placed on the Remuneration Committee, the determination and disclosure of remuneration and a substantial amount of guidance was provided. The Institute of Directors of Southern Africa issued a practice note in 2009 entitled 'Remuneration Committee Terms of Reference'. This practice note was essentially a template for the establishment of a Remuneration Committee to be adjusted for each company as required. It dealt with the purpose, composition, role,

[89] King Committee (2002). Page 198.
[90] The Institute of Directors of Southern Africa – The King III Code (2009) Principle 2.23.6.
[91] The Institute of Directors of Southern Africa – The King III Report (2009) Principle 131.
[92] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 150.1.

responsibilities, authority, meeting procedures, and the approval of the terms of reference of the Remuneration Committee.[93] The second practice note issued, entitled 'A Guide to the Application of King III: Remuneration', was issued in 2012. The practice notes draw on the principles espoused in King III Code and the practice recommendations in the King III Report and provide practical guidance as to how to implement the principle.[94] The practice note additionally provides a sample Remuneration Strategy Framework,[95] guidance on the formulation and consideration of short term incentive design standards,[96] and finally a template for the remuneration report[97] to be disclosed in the annual financial statements.[98]

Under the current regime of corporate governance, including the issued Practice Notes, the functions of the Remuneration Committee can be divided into two broad categories. The first is the setting and administering of a Remuneration Policy. The second relates to disclosure.

The first function is that of devising a Remuneration Strategy[99] to convey the company's philosophy of remunerating directors with the underlying principle of aligning the remuneration package with the company's strategy, risk appetite, shareholder interests, and long-term goals. This Remuneration Strategy must be approved by the Remuneration Committee and confirmed by the Board.[100] The purpose of the Remuneration Policy is to give effect to the strategy and deals in greater detail how the remuneration packages should be structured.[101] The Practice Notes suggest that remuneration packages should include a mix of fixed and variable pay to strike a balance between the need to motivate directors over the short term, long term, align their interests with those of the company and shareholders, and to attract and retain

[93] The Institute of Directors of Southern Africa *Practice Notes – King III Chapter 2: Remuneration Committee Terms of Reference* (2009) pages 1 - 5
[94] The Institute of Directors of Southern Africa *Practice Notes – A Guide to the Application of King III: Remuneration* (2009) pages 1 – 29.
[95] The Institute of Directors of Southern Africa (2009) pages 20 – 22.
[96] The Institute of Directors of Southern Africa (2009) pages 23 – 25.
[97] The Institute of Directors of Southern Africa (2009) pages 26 – 29.
[98] The Institute of Directors of Southern Africa *Practice Notes – King III Amendment* (2012) pages 5.
[99] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 147.1.
[100] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 147.3.
[101] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 147.2.

directors of sufficient caliber.[102] Within the remuneration policy, the Committee should also set incentive targets geared towards the short and long term performance and interests of the company and devise measures to effectively measure the performance of the directors in that regard.[103] The Practice Notes deal extensively with the determination of bonuses[104] to be related to annual performance target and suggests that those targets and related awards be reviewed annually.[105] This Remuneration Policy is subject to a non-binding advisory vote by the shareholders at the annual general meeting of 50%.[106] The purpose of this is said to provide the shareholders to express their opinion on the structure of remuneration including salary, benefits, and short and long term incentives.[107] The board is not obliged to consider the outcome of the vote. Although the board is not obliged to consider the outcome of the vote, it does provide shareholders to express discontent regarding remuneration and may result in the board adjusting its remuneration packages. The types of remuneration provided for in terms of the Code are normal base salary, short term annual performance bonuses which usually take the form of cash, long term incentives which usually take the form of share schemes with differing vesting periods to align interests and retain directors, pension and other contributions, and severance payments.

The second function is that of disclosure. This is provided for in principle 2.26 of the Code and expanded upon in Practice Recommendations 180 to 182 of the Report and notes 180.1 to 182.3 of the Practice Notes. The disclosure of remuneration of directors takes place in the Remuneration Report to be included in the Integrated Report,[108] which is to contain base salary, awards, benefits, the value and basis of long and short term incentives, the value of all unvested and unexercised awards of stock options and those already vested and exercised.[109] The notes contain a section of what is to be included in the Report such as the objectives the remuneration strategy seeks to

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[102] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 151.1.
[103] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice notes 151.1 – 151.4.
[104] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 157.1 – 158.4.
[105] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 158.3.
[106] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 186.1, The Institute of Directors of Southern Africa – The Code (2009) Principle 2.27, The Institute of Directors of Southern Africa – The Report (2009) Practice Recommendation 186.
[107] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 186.3.
[108] The Institute of Directors of Southern Africa – The Amendment (2012) Principle 2.26.
[109] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 180.1 – 180.5.

achieve, a summary of the guaranteed remuneration packages and short and long term incentive schemes, and an explanation of how the incentive schemes are to be implemented.[110]

When comparing the Code to international corporate governance codes, the recommendations in the King Code are largely similar to those put forward by the International Corporate Governance Network[111] and the UK Corporate Governance Code[112] regarding the determination of remuneration. A few fundamental differences may be pointed. The first is that the UK Corporate Governance Code requires that *all* members of its remuneration committees be independent non-executive directors[113] as opposed to South Africa's majority of independent directors. The second is that ICGN is opposed to any 'guaranteed' elements of remuneration[114] whereas the King Code does provide for guaranteed elements of remuneration, but wisely excludes long and short term incentives.[115] Thirdly, while the King Code state that shareholders should not have any input regarding the remuneration of executive directors, affording them only a non-binding advisory vote, the ICGN and the UK Code recommends that any share-based remuneration which could result in a dilution of shareholdings should be subjected to shareholder approval.[116] The United States has similar requirements in terms of its tax laws for the approval of any share-based awards or amendments to such schemes.[117] [118]

As regards the disclosure of remuneration, the substance of what needs to be disclosed in the remuneration report is largely similar between the ICGN, the UK Code, and the

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110 The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 181.1
111 The International Corporate Governance Network *ICGN Executive Remuneration: Principles and Policy Disclosure Guidance* (2012) Principles 2.0 – 2.5.
112 The Financial Reporting Council *The UK Corporate Governance Code* (2012) Section D.
113 The Financial Reporting Council (2012) Provision D.2.1.
114 The International Corporate Governance Network (2012) Principle 2.1.
115 The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 157.1
116 The International Corporate Governance Network (2012) Principle 2.4.
117 Peter King, Holly Gregory, Lauren Pau and Rebecca Grapsas Weil, Gotshal & Manges LLP *Corporate Governance and Directors' Duties multi-jurisdictional guide 2012/13* (2013) *Disclosure of executive remuneration in the UK: recent developments and US comparison*. Page 5 http://www.weil.com/~/media/files/pdfs/Disclosure_of_executive_remuneration_in_the_UK.pdf (accessed 15 August 2014)

118 sections 162(m) and 423, Internal Revenue Code of 1986

King Code. However, in since 1 October 2013, remuneration disclosure in the UK became compulsory as required by section 420(1) of the Companies Act 2006 (CA) where the contents of the report are prescribed by the Large and Medium-sized companies and Groups (Accounts and Reports) Regulations 2008. This is similar to the position in the United States where the Securities Exchange Commission requires disclosure regarding director compensation in a proxy statement provided to the shareholders, the annual reports, and registration statements of the company.[119] This is further supplemented by the Dodd-Frank Financial Reform Act[120] which requires additional expanded disclosure relating to the remuneration paid compared to the actual performance of the company, amoung others. Other countries which have mandatory disclosure requirements include Canada, Ireland, France, and Germany. The United States has the most stringent, comprehensive, and costly compliance regimes,[121] however it seems that the larger world economies employ a legislated approach to disclosure of director remuneration. The 'apply or explain' approach to corporate governance does have advantages in that it is flexible and subject to easy amendment as opposed to the tedious processes of statutory amendment, however as seen with King I and King II, important aspects of corporate governance which become standard procedure are codified into legislation or regulation. Provisions regarding disclosure have been codified in the Companies Act of 2008[122] to keep up with international best practice and the protection of shareholders through information. However, having more stringent disclosure requirements is particularly important in the context of mergers and acquisitions (M&A). The King III Report does make provision for the consideration of M&A activity in Practice Recommendation 166[123] where it states that the 'Remuneration Committee should regularly review incentive schemes to ensure their continued contribution to shareholder value…and guard against unjustified windfalls and inappropriate gains from the operation of share-based incentives'. It is further supplemented by Practice Note 166.1 which acknowledges M&A but in the context of

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119 The Securities Exchange Commission *Executive Compensation* http://www.sec.gov/answers/execomp.htm (accessed 15 August 2014)
120 Dodd-Frank Financial Reform Act of 2010 Sections 951 - 955
121 The Institute of Directors of Southern Africa – The Code (2009) Page 4.
122 Companies Act No. 71 of 2008, Section 30(4) – 30(6).
123 The Institute of Directors of Southern Africa – The Report (2009) Practice Recommendation 166.

share price variations during announcement and negotiation stages.[124] These provisions are sufficient to guard against any short term variations in share prices which may trigger the activation of bonus provisions, however this is does not guard against the long term effects of M&A as shown in the economic evidence on event studies. The King Code[125], Report[126], and Practice Notes[127] states that remuneration policies, when awarding performance bonuses, should consider the effect of external factors which could affect the performance of the company but to which the directors have made no contribution to, such as oil, gold or platinum prices.[128] This, again, does not mitigate the risk alluded to above. Additionally, Practice Note 147.4 states that 'the company should indicate in the Remuneration Report the manner in which director remuneration is related to the value-created for shareholders and other stakeholders.' This dissertation submits in this regard, firstly that the value created for shareholders as a result of M&A has only been shown to accrue after a period of approximately three years and as a result, any short term annual bonuses are not related to value created for shareholders. Secondly, that the gains accruing from M&A activity, such as increased production, lower cost of production, increased output, increased market share etc. which may trigger short term annual performance bonuses, are as a natural consequence of the merger or acquisition in and of itself, and not from the conduct of the directors in innovating or developing the company's operations to achieve those results. The gains made from M&A are therefore more akin to external factors which should be considered when awarding bonuses, and therefore constitute an unjustified award.

4. Mergers and acquisitions: a brief discussion

Companies can achieve growth in two manners; firstly, in the ordinary course of business, referred to as internal or organic growth, and secondly through external

[124] The Institute of Directors of Southern Africa – The Practice Notes (2012) Practice Recommendation 166.1.
[125] The Institute of Directors of Southern Africa – The Code (2009) Principle 2.25.
[126] The Institute of Directors of Southern Africa – The Report (2009) Practice Recommendation 148.
[127] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice notes 148.1.
[128] The Institute of Directors of Southern Africa – The Practice Note (2012) Practice note 148.1.

growth by acquiring existing businesses.[129] Mergers and acquisitions (M&A), or an amalgamation or merger as it is referred to in the Companies Act (the Act), are classified as a category of Fundamental Transactions.[130] An amalgamation or merger is defined in the Act as:

> [A] transaction, or series of transactions, pursuant to an agreement between two or more companies, resulting in –
>
> (a) the formation of one or more new companies, which together hold all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies; or
>
> (b) the survival of at least one the amalgamating or merging companies, with or without the formation of one or more new companies, and the vesting in the surviving company or companies, together with such new companies, of all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement.

A merger takes place between a target company and an acquiring company, involving a process of acquiring, selling, or combining of firms[131] resulting in a new company being formed or one of the surviving with the other ceasing its existence. This is provided for in the definition of an amalgamation or merger in subsections (a) and (b) respectively. The choice between the two structures of mergers will depend on the underlying reasons for the merger and be determined by a number of factors. Examples of these factors are, first, the wish to convey a message that the merger was a transaction between equals, necessitating the formation of a new company.[132] Second, the need to maintain and exploit the goodwill and identity of one the parties to the merger which

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[129] M. Stafford (2012) page 7.
[130] Companies Act 71 of 2008, Chapter 5.
[131] Mehroz Dilshad *Profitability Analysis of Mergers and Acquisitions: An Event Study Approach* (2013) Vol. 3, No. 1 *Business and Economic Research.* Page 90.
[132] Farouk H I Cassim et al *Contemporary Company Law 2ed* (2012) page 680.

would necessitate the retention of the relevant company's name with the other being absorbed and dissolved.[133] And, provisions in contracts with third parties, such as assignment or cession provisions in service agreements, regarding change in control or ownership of a contracting party could also determine which company name survives or if a new name should be created.[134]

The theories as to why companies merge has been thoroughly developed and generally be divided into two categories; neoclassical theories and behavioral theories.[135] Neoclassical theories are premised on the assumption that managers are rational and make rational decisions to maximize shareholder wealth.[136] Behavioral theories are premised on the assumption that managers are not rational and act in their own interests[137] as espoused in the hubris theory and agency theory.

It has been submitted that amongst the most important neoclassical reasons cited for M&A are the following: creating synergy between companies which is described as increasing the competitiveness of the merged company.[138] Synergies create cash flows in excess of what the two companies would generate independently if they were not merged and therefore essentially based on the economic benefit resulting from the merger.[139] The synergy motive has been further refined into operational and financial synergy.[140] The former is essentially based on economies of scale whereby the merged firm essentially exploits the best of both companies' manufacturing and production processes to reduce production costs, increase profits and thus provide the potential to increase its or their operating income.[141] Operational synergies are also related to managerial efficiencies through the reduction of unnecessary managerial positions[142] and optimizing the skills and expertise of existing managers. This is related to diversification and cost reductions. Financial synergy, on the other hand, is premised on

[133] F Cassim et al (2012) page 681.
[134] F Cassim et al (2012) page 681.
[135] M. Dilshad (2013) page 90.
[136] M. Dilshad (2013) page 91.
[137] M. Dilshad (2013) page 91.
[138] M. Stafford (2012) page 7.
[139] Justice Kyei-Mensah *Wealth Effects of Mergers and Acquisitions for U.S. Firms: Using Alternative Pricing Models* PhD (University of Ashton) 2011, page 26.
[140] J. Kyei-Mensah (2011) page 27.
[141] J. Kyei-Mensah (2011) page 27.
[142] M. Dilshad (2013) page 90.

the merger of the finances of the two companies and exploiting resultant benefits therefrom. With the merger of capital and cash, the firms' insolvency ratios decrease while the firm's debt capacity increases.[143] The cost of capital, or the cost to obtain debt such as interest rates, of the combined firm is reduced owing to the reduced risk of insolvency and the expectation is that the combined firm will become more cost efficient, profitable, increase in size, and have a bigger opportunity for future profit maximization.[144]

A second reason for M&A, as alluded to above, is achieving economies of scale. Economies of scale can be simply defined as producing more for less because of the size. It is said that the bigger a corporation is, the more efficient its inputs and labour can be.[145] As a result of the increased quantity of goods produced, costs of production per unit are shared over a larger number of units thereby increasing the profits.[146] Firms draw from operational and financial synergies to use production efficiencies, techniques, and know-how from one another to create a more efficient and therefore cheaper method and cost of production, thereby increasing output and profits.[147]

A third reason suggested for M&A is the reduction of risk and diversification. Certain forms of diversification are said to reduce risk, for example if a firm selling or producing one product diversifies by acquiring a firm which produces a totally different product, the risk of failure of the firm is reduced in that if one product fails, there is another product to fall back on and all the eggs are not in one basket as it were.[148] Diversification therefore reduces the risk and volatility associated with share prices.[149] The underlying reason for diversification can be stock or product based, or may be targeted at labour related aspects whereby management and employees are diversified or placed in different roles to exploit possible operational synergies.

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[143] J. Kyei-Mensah (2011) page 28.
[144] J. Kyei-Mensah (2011) page 28.
[145] George Coontz *Economic Impact of Corporate Mergers and Acquisitions on Acquiring Firm Shareholder Wealth* (2004) Vol. 12 No.1 *The Park Place Economist*. Page 62.
[146] George J. Stigler et al *Business Concentration and Price Policy* (1955) page 213 – 216.
[147] J. Kyei-Mensah (2011) page 27.
[148] G. Coontz (2004) page 62.
[149] J. Kyei-Mensah (2011) page 28.

An important motivation for M&A activity which falls under the Behavioral theory, is the hubris motive.[150] The premise is that acquiring firms pay higher amounts for the target firm above its true economic value[151]. In terms of the hubris theory, management of the acquiring company believe that they should acquire a company as they can create more value from the firm than its existing management. This belief is based on a hubris or arrogant mistake and over estimation of their ability to extract value from the acquired company and create value.[152] This usually results in value destruction for shareholders and is often cited as a reason for failure of a merger or acquisition.[153]

The second motivation falling under the Behavioral theory is Agency which states that takeovers occur as it is in the interests of the management of the acquiring company but at the expense of the acquiring company's shareholders.[154] Agents (managers) are paid to make decisions on behalf of the principal (shareholders), this payment is known as the agency cost.[155] To align the interests of the agent with those of the principal share options are often granted, however, the one of the quickest ways to achieve growth is through M&A which could be exploited by managers to maximize their own contractual benefits[156] as discussed earlier. These are essentially selfish and self-interested actions by management. In amplification of this line of argument is the fact various studies have a strong positive relationship between the size of the company and remuneration,[157] where some studies have even shown a stronger link between size and remuneration as opposed to performance and remuneration.[158]

Other common reasons management may decide to enter in M&A activity include, to increase a firms market share with regard to specific product by acquiring a competitor, or acquiring a foreign company to gain access into the foreign market. Acquiring

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[150] J. Kyei-Mensah (2011) page 21.
[151] J. Kyei-Mensah (2011) page 21.
[152] Richard Roll *The Hubris Hypothesis of Corporate Takeovers* (1986) Vol 59, No. 2, page 197.
[153] M. Stafford (2012) page 26.
[154] M. Stafford (2012) page 8.
[155] H. E. Scholtz *Share Options as Part of Executive Remuneration: Aligning the Interests of Stakeholders* (2009) Vol. 13, No. 2. Page 58.
[156] M. Dilshad (2013) page 92.
[157] Sourafel Girma, Steve Thompson & Peter Wright *Merger Activity and Executive Pay* (2002) Research Paper 2002/02 *Globalisation and Labour Markets Programme*, University of Nottingham.
[158] Paul Guest *The Impact of Mergers and Acquisitions on Executive Pay in the United Kingdom* (2007) Working Paper No. 354, *Centre for Business Research* University of Cambridge.

companies also acquire target companies so as to acquire technology, intellectual property, patents or trademarks. Management may also have more malevolent reasons (hubris and agency) for conducting M&A activity, such as greed, empire-building, and the desire to establish monopolies or oligopolies and enjoy monopolistic or oligopolistic profits.

In a 2009 study, Bain and Company found that up to 70% of all mergers failed, a finding which was also confirmed by McKinsey and Company.[159] Some of the important reasons put forward for the failures of M&A are: firstly, the size of the premium paid (or overpaid) for the target companies often nullifies any positive returns as will be shown in the chapter on event studies.[160] The second reason of great importance is the failure of management to efficiently integrate the organizations[161] which relate to issues of the corporate culture differences between the two entities, incompatibility of partners, or inability to appropriately integrate existing employees or executives into new roles.[162] Integration was also cited by McKinsey and Company as one the main causes of failure of M&A. The hubris theory is also propounded as a cause for failures in that management is said to over-estimate their capabilities to extract or generate value, or over-estimate the value of their previous experience in M&A, or their ability to manage a diversified company or diversified products.[163] Inadequate or incomplete due diligence on the target company, inefficient communication and planning can also result in failure.[164]

Given that such a large percentage of M&A's fail and that the findings of event studies, which are discussed in another section, also empirically prove that M&A does not create real value for shareholders, why do managers of companies choose to engage in M&A if not for reasons other than self-interested ones? Corporate governance structures fail to protect shareholders this regard as disclosure requirements imposed on

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[159] McKinsey & Company *Perspectives on Merger Integration* (2010) page 11.
[160] G.V.M. Kode et al *A Conceptual Model for Evaluation of Synergies in Mergers and Acquisitions: A Critical Review of the Literature* (2003) Vol. 50 No. 1 *South African Journal of Finance.* Pages 185-222
[161] G.V.M. Kode et al (2003)
[162] M. Stafford (2012) page 26 - 27.
[163] M. Stafford (2012) page 26.
[164] Thuy Vu Nga Lapumnuaypon Hoang *Critical Success Factors in Merger & Acquisition Projects: A Study from the Perspective of Advisory Firms* MBA (Umea University) 2007, page 61 – 62.

Remuneration Committees are insufficient and the formulation of remuneration of remuneration practices are not in keeping with international best practice. This insufficiency was alluded to in the chapter dealing with Remuneration Committees under the King Code.

5. Event studies in South Africa

Event studies can be defined as an empirical study and analysis of the behavior or reactions of a firm's securities or stock prices in relation to a specific corporate event.[165] The analysis may occur over a period of days, months or years, with the general aim of detecting abnormal performance affecting shareholder wealth and impact of corporate policy decisions.[166] Event studies have a long history and have been published since 1933 and have had various subsequent applications and adaptations.[167] For the purposes of this research, event studies that considered the change in the value of shares in companies for varying periods after the completion of a merger or acquisition, being the event, were considered. This change in the share price enables one to determine whether the merger created value for the shareholder, or destroyed value.

Although not a great deal of research exists regarding the long-term impacts of merger and acquisition (M&A) activity on the share prices of companies in the South African context, a study conducted in 2004 to a large extent confirmed international findings that M&A activity does not create persistently positive returns over the long term[168] creating negative returns or in the alternative no positive return. A study conducted in 2006 similarly concluded that shareholders of acquiring companies do not earn statistically significant returns and described M&A activity as 'zero net present value

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[165] B. Espen Eckbo *Handbook of Corporate Finance, Volume 1: Empirical Corporate Finance* 1ed (2006) page 5.
[166] B. Espen Eckbo (2006) page 5.
[167] A. Craig MacKinlay *Event Studies in Economics and Finance* (1997) Vol. XXXV *Journal of Economic Literature* page 13
[168] T. Wimberley and M. Negash *The Value Creation Effects of Mergers and Acquisitions: Evidence from the JSE Securities Exchange South Africa* (2004) Vol. 59 *Investment Analysts Journal* page 39

investments',[169] meaning that no significant value is created. This latter study further analysed the effect on the merged company's operating financial performance and further differentiated between cash-funded acquisitions and share-funded acquisitions. A more detailed examination of these studies follows below.

The 2004 study examined the long-term effects of M&A activity on share prices for companies listed on the JSE. Its point of departure is based on the premise that the short-term effects of M&A was proved to generally create value for shareholders in that the shareholders of target or acquired companies experienced abnormal gains of between 30% and 44%, whereas acquiring firms' shareholders experienced gains of between -2% and 11%.[170] This was stated to be as a result of the expectation of positive or improved future performance of the merged company, however the share price reaction obviously not indicate whether the expectation would prove to be correct,[171] hence the need for an examination into the long-term overall effects on share prices from M&A activity. The authors enumerate three methodologies used in long-term even studies as follows. Firstly, Cumulative Abnormal Returns (CAR) which calculates the sum of each of the average monthly abnormal returns. Second, the Buy and Hold Abnormal Returns (BHAR) which calculates the abnormal return over a specified period starting from the date of the merger ending after a specific period. Finally, in the Calendar Time Abnormal Returns (CTAR) 'a portfolio is created every month containing all firms that completed a merger' during a specified time comparing one month's return to the previous month's return.[172] The study used companies in the industrial sector which entered into M&A transactions as it provided a good representation of M&A activity in terms of value and number of transactions over the decade prior to the study in South Africa.[173] The study aimed to determine the effects of

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[169] C. Smit and M Ward *The Impact of Large Acquisition on the Share Price and Operating Financial Performance of Acquiring Companies Listed on the JSE* (2005) Vol. 65 *Investment Analysts Journal* page 13
[170] T. Wimberley and M. Negash (2004) page 31.
[171] T. Wimberley and M. Negash (2004) page 31.
[172] T. Wimberley and M. Negash (2004) page 32.
[173] T. Wimberley and M. Negash (2004) page 32.

M&A for the period 1989 to 1998 in a total of 609 listed companies with the event window period being 36 months after the first announcement of the M&A.[174]

In its results, the study found that at 3 months and 14 months after an M&A event, measured firms showed CAR's of basically zero, meaning that no abnormal return was generated.[175] The period between 14 and 18 months after the M&A activity remained neutral after the 18th month when a negative trend occurs generating negative abnormal returns.[176] The returns remain negative until months 24 to 32 after the M&A event which then shows a slight positive trend, followed by another negative trend from months 32 to 36 after the M&A event.[177] At the 36th month after the M&A event, CAR's were at its lowest at -10.5% and it is submitted that any abnormal positive returns recorded were so slight that they could not counteract the abnormal negative returns.[178]

In the sensitivity analysis, the firms were further divided into value firms, neutral firms, and glamour firms. The former having high book to market ratios,[179] and glamour firms having low book to market ratios. The study showed that value firms showed positive CAR's in the first and third years after the M&A, whereas neutral and glamour firms showed consistently negative returns for the whole period.[180]

Additionally the study examined the effect of M&A activity in relation to how the acquisition was financed. The results indicated that where a transaction was financed solely through share offerings, it produced negative abnormal returns for both Neutral and Glamour firms but not for Value firms, whereas if the transaction was cash financed all classifications of companies generated negative returns.[181] This contradicted finding

[174] T. Wimberley and M. Negash (2004) page 33.
[175] T. Wimberley and M. Negash (2004) page 36.
[176] T. Wimberley and M. Negash (2004) page 36.
[177] T. Wimberley and M. Negash (2004) page 36.
[178] T. Wimberley and M. Negash (2004) page 36.
[179] Book to market ratio means the ratio of the book value of the firm, looking at its accounting value or assets and liabilities, and the market value as determined by its market capitalization. (http://www.investopedia.com/terms/b/booktomarketratio.asp) accessed 28 July 2014.
[180] T. Wimberley and M. Negash (2004) page 37.
[181] T. Wimberley and M. Negash (2004) page 38.

in another study conducted in 1998 which found that Value firms generated positive returns and Glamour firms generated negative returns.[182]

In conclusion the study found that M&A activity does not create persistently positive abnormal returns over the long-term. The largest negative return period occurs between the 13th and 24th month after the M&A activity, and that the method of financing the transaction did not have a significant impact on the overall results. The study indicated that for a shareholder to maximize its returns, it should release its shares in an M&A active firm after seven months of the announcement of an M&A event as this is the highest positive return period. The findings are congruent with similar research in the United States and the United Kingdom.[183]

Later in 2005 a study was again conducted to determine whether large acquisitions which occurred from 2001 to 2003 created value for the shareholders of the acquiring companies listed on the JSE.[184] The authors noted that a KPMG survey in London indicated that 53% of M&A destroys shareholder value.[185] In this study what was examined was the share price performance during the period of the announcement of the M&A and the subsequent impact on the share price during a two year period after the completion of the acquisition, and secondly the impact on the operating financial performance of the merged company in the two years succeeding the merger.[186] This study attempted to prove or disprove two hypotheses; first that shareholder of acquiring companies do not earn positive or negative abnormal cumulative returns around the announcement of M&A activity, considering cash and share-financed M&A.[187] Second, that the industry adjusted cash flow returns on tangible assets of the merged company after the merger is the same as the average industry adjusted cash flow return on tangible assets of the two combined companies before the merger.[188] This latter hypothesis was also considered for both cash and share-financed transactions.

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[182] T. Wimberley and M. Negash (2004) page 38.
[183] T. Wimberley and M. Negash (2004) page 39.
[184] C. Smit and M. Ward (2005) page 5.
[185] C. Smit and M. Ward (2005) page 5.
[186] C. Smit and M. Ward (2005) page 5.
[187] C. Smit and M. Ward (2005) page 7.
[188] C. Smit and M. Ward (2005) page 7.

The data used was obtained from the Ernst & Young annual review of M&A for the years 2000 to 2002, market capitalization of acquiring firms from the McGregor's BFANet database, and specific financial information from the companies' actual financial reports.[189] The number of M&A transactions analyzed amounted to only 27. The first step in this study was to determine the expected return which would occur post acquisition. This was done using the Control Portfolio Model methodology whereby all listed companies were classified into eight control portfolios using 'combinations of the book to market ratio discussed above, company size, and the resource effect'.[190] The shares were then categorized into one of these eight control portfolios, the daily share prices of each portfolio were obtained and the daily return could be estimated, and rebalanced every month to maintain an accurate measure of share price returns as a result of changes in book to market ratios, capitalizations, new listings and delistings.[191] This was then measured and analyzed against the share price information obtained for specific acquisitions to determine the changes in share prices during the ten day period before and after the announcement of the M&A. The impact on post-acquisition cash flow return or operational financial performance was measured by comparing the cash flow returns to the median cash flow returns for the industry sector for a period of two years before and after the completion of the acquisition.[192]

In respect of the first hypothesis regarding the impact on the share price, the study found a small Average Cumulative Abnormal Return over the 21 day period during the announcement of the acquisition and a negative return one day before and after the announcement of the acquisition.[193] It is submitted that these positive and negative returns are statistically insignificant in the broader context. The study confirmed the results of international studies which found that share-funded acquisitions created negative abnormal returns whereas cash-funded acquisitions create positive abnormal returns over the short term.[194] It is submitted that this is owing to the message that

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[189] C. Smit and M. Ward (2005) page 7.
[190] N. Mordant and C. Muller *Profitability of Directors' Share Dealings on the JSE* (2003) Vol. 57 *Investment Analysts Journal*. Page 17-21
[191] C. Smit and M. Ward (2005) page 9.
[192] C. Smit and M. Ward (2005) page 9.
[193] C. Smit and M. Ward (2005) page 10.
[194] C. Smit and M. Ward (2005) page 11.

share-funded acquisitions convey that the shares of the acquiring company are overvalued[195] in that the company can offer shares in lieu of a large amount of currency. Cash-funded transactions on the other hand conveyed the positive message that the shares of the acquiring company are undervalued[196] creating an incentive for investors to invest in the company.

Regarding the second hypothesis, the study found that no statistically significant Industry-Adjusted Cash Return on Tangible Assets were recorded during the two year period before or after the merger. It also found no statistically significant difference between the results for cash-funded or share-funded transactions, however, the results did indicate that in general, share-funded acquisitions created a more favourable cash return on assets.[197] Both share and cash-funded transactions produces negative cash returns in the second year after the merger, however these amount were statistically insignificant at -0.17% and -0.10% respectively.[198] The overall conclusion of this study regarding financial performance after a merger was that M&A does not result in any improvement or deterioration in the operating financial performance of the merged company.[199] This is congruent with international studies suggesting that M&A are, on average, zero net present value investments[200] whereby when taking into account the premium paid for the shares of the target company or the additional amount above the actual market value of the shares, no additional cash flows will be generated which are sufficient to cover the premium paid. Secondly, M&A creates no statistically significant Average Cumulative Abnormal Returns in the short term, however cash-funded acquisitions created statistically insignificant positive returns whereas share-funded transactions created negative short term returns.[201]

This 2005 study was supplemented in 2008 by one Kofi Kyei, who used the same sample as Ward and Smit in an attempt to supplement their findings that M&A does not create statistically significant cumulative abnormal returns, nor does it significantly

[195] C. Smit and M. Ward (2005) page 11.
[196] C. Smit and M. Ward (2005) page 11.
[197] C. Smit and M. Ward (2005) page 12.
[198] C. Smit and M. Ward (2005) page 11.
[199] C. Smit and M. Ward (2005) page 12.
[200] C. Smit and M. Ward (2005) page 12.
[201] C. Smit and M. Ward (2005) page 13.

create or destroy shareholder value.[202] The only difference this study found, compared to all other research in the area, regarded the method of finance of the M&A in which it found that share-funded M&A yielded higher positive results than cash-funded transactions.[203] On all other aspects, the results of the study were consonant with and confirmed previous findings.[204]

Finally the last study pertaining to the long term effects of M&A activity on share price performance was conducted by M Stafford in 2012, also emanating from the University of Pretoria's Gordon Institute of Business Science.[205] This study examined the short term effects of M&A activity and the long term effects by examining a considerably longer period of ten years (1999 to 2008) which was longer than the periods examined by Wimberley in 2004, Smit in 2005, and Kyei in 2008.[206] Stafford tested the generation of Average Abnormal Returns (AAR) and Average Cumulative Abnormal Returns (ACAR) over the short term and the long term, and postulated that cash versus share funded acquisitions generated similar ACARs over the short and long term.[207] The study tested its hypotheses over six different event windows, a 3-day event window (-1; +1),[208] a 21-day (-10; +10), 126-day, 189-day and 229-day event window.[209]

For the full duration of the study, the findings were that the Average Abnormal Returns (AAR) averaged 0.06%, were at its highest at 3.66% and lowest at -1.64%.[210] AARs for cash-funded acquisitions were highest at 4.72%, lowest at -2.64% with an average of 0.06%.[211] Share-funded acquisitions AARs peaked at 3.66%, troughed at -1.64% and averaged at 0.03%.[212] The study showed that the returns generated were all positive. Even though the statistics are statistically insignificant in that the AARs are so small and

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[202] K. Kyei *The Long Term Impact of Large Acquisitions on the Share Price Performance of Acquiring Companies listed on the JSE* MBA (Pretoria) 2008.
[203] K. Kyei (2008) page 79.
[204] K. Kyei (2008) page 84.
[205] Mark T.G. Stafford *The Short and Long Term Effects of Large Takeovers on the Share Price Performance of Acquiring Companies Listed on the JSE* MBA (Pretoria) 2012.
[206] M. Stafford (2012) page 5.
[207] M. Stafford (2012) page 33 – 35.
[208] The numbers signify the days before and after the significant event (merger), counted as 0.
[209] M. Stafford (2012) page 88.
[210] M. Stafford (2012) page 85.
[211] M. Stafford (2012) page 85.
[212] M. Stafford (2012) page 85.

not statistically different from zero, the findings are significant in that they are different to previous findings in the sense that the returns generated were numerically positive. The study additionally found that, contrary to all previous South African research, share-funded acquisitions generated more positive returns than cash-funded acquisitions over the short term.[213] The findings later conformed to previous findings over the longer term in this regard. Regarding ACARs, the study found statistically insignificant positive returns over the long term[214] which supported the findings of Kyei in 2008, but contradicted Wimberley in 2004.[215] Finally, the study found that there is no difference in ACARs as between cash-funded transactions or share-funded transactions over the short or long-term and that both produced similar statistically insignificant positive returns.[216]

When comparing the results of event studies of foreign jurisdictions, it is important to note the observations of Stafford (2012) who differentiated between studies in the Developed world or Developed economies and the Developing world or economies.[217] Although South Africa is a Developing country, it is submitted that its 'financial markets and institutions are more akin to those which prevail in the Developed World'.[218] The majority of international event studies are geared towards measuring the abnormal returns over short term intervals around the period of the announcement or conclusion of a merger or acquisition. The reason why most international studies are short term studies is as a result of the reliance on the economic theory of the 'efficient market'[219]. This theory states that the 'share price of a company should almost immediately adjust to include the effects of the M&A announcement'[220] and that the share price as reflected immediately after the transaction should provide the investor with a reliable prediction of the future benefit of the M&A.[221] The studies in international studies concluded that M&A transactions on average created no value in that the share prices either increased

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[213] M. Stafford (2012) page 87.
[214] M. Stafford (2012) page 91.
[215] M. Stafford (2012) page 91.
[216] M. Stafford (2012) page 93.
[217] M. Stafford (2012) page 14.
[218] M. Stafford (2012) page 15.
[219] M. Stafford (2012) page 16.
[220] M. Stafford (2012) page 16.
[221] R. Kumar and S. Panneerselvam *Mergers, Acquisitions and Wealth Creation: A Comparative Study in the Indian Context* (2009) Vol. 21, No.3 page 222.

or decreased immaterially after the announcement of an acquisition.[222] Studies from the Developing world had diametrically opposed results which stated that M&A does create value for the shareholders over the short term and long term.[223] Stafford suggested that reasons for the differing results are the different institutional environments and the different attitudes towards mergers and acquisitions in Developing countries, where the shareholders of acquiring companies regard acquisitions as positive whereas shareholders of target companies hold the opposite view.[224]

It is clear that the studies conducted internationally, and indeed locally, bear a basket of mixed fruits. No two studies have generated findings so certain that one could definitively state that M&A activity creates or destroys shareholder value, or that financing M&A through cash or shares will result in greater returns. The one finding which can undoubtedly be deemed as a common denominator in all studies is that the AARs and ACARs, whether positive or negative, are statistically insignificant. Put differently, the positive or negative returns made, if any, are of such a small amount that they are inconsequential. The same holds true for the converse. The overall results of the studies conducted in South Africa were more congruent with the studies of the Developed world, as suggested by Stafford (2012), in that in the period after the announcement or conclusion of merger or acquisition there are small gains, however there is more evidence that M&A does not create value over long term.

6. Summation and Recommendations

From the aforegoing, the following summation is proffered: the basic goal of the directors is to make the make the company successful.[225] The directors stand in a fiduciary relationship to the company and have a fiduciary duty towards the company which are based on notions of loyalty, good faith and avoidance of conflicts of interests as espoused in English law.[226] The duties of a director were codified in Section 76 of the

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222 M. Stafford (2012) page 97.
223 M. Stafford (2012) page 94.
224 M. Stafford (2012) page 15.
225 F. Cassim *et al* (2013) page 514.
226 F. Cassim *et al* (2013) page 509.

Companies Act of 2008. The best interests of the 'company'[227] has been ascribed the common-law meaning as referring to the 'interests of the collective body or present and future shareholders'.[228] This relationship between the director and the shareholders can further be classified as an Agent-Principal relationship whereby the directors, act as agents of the shareholders as principals. The agency theory further suggests that a conflict of interest arises in that the agent acts in his own interests as opposed to the interests of the shareholder, known as the agency problem. The method suggested to mitigate this problem is through agent's remuneration package, known as the agency cost. This forms the basis of the remuneration of directors of companies and informs the structure of the remuneration package.

Modern South African corporate governance structures do provide relatively sufficient regulation and guidance as to how to mitigate this agency problem. It provides that Remuneration Committees *should* be formed to determine remuneration packages for directors with the aim of aligning the interests of the directors with those of the shareholders through short and long term incentives, and to prepare disclosure of certain remuneration related information.[229] It is submitted that in the ordinary course of business, these recommendations would suffice. It is in the context of Mergers and Acquisitions (M&A) where the recommendations of the King Code *et al* begin to fall short.

Mergers and Acquisitions are defined as a transaction or transactions whereby one company is acquired by another resulting in one surviving or a new merged company. M&A are considered to be one of the fastest ways to achieve growth in a company and the reasons for entering into M&A are vast and plentiful. However, having regard to the fiduciary duty of directors owed to the shareholders, one would expect the main reason to be in the best interests of the shareholders and consequently to create shareholder value. One of theories suggested for entering into M&A is the Agency Theory, which as stated above suggests that managers act in their own interests. It is submitted that this

[227] Companies Act No. 71 of 2008, Section 76(3)(b)
[228] F. Cassim *et al* (2013) page 515.
[229]The Institute of Directors of Southern Africa – The Code (2009), The Institute of Directors of Southern Africa – The Report (2009), The Institute of Directors of Southern Africa – The Practice Note (2012)

is the most likely reason for entering into M&A activity as positive links have been found between company size and director remuneration.[230] The most convincing evidence that the Agency Theory is responsible for M&A is that of Event Studies. These are studies which analyze the fluctuations of share prices of companies around the occurrence of certain events. Two types of event studies are usually conducted, being those that consider only the price movements upon the announcement of M&A, and secondly those that consider the long term price movements after M&A. The results of these studies found that real shareholder value is *not* created by M&A for a period of at least three years after the conclusion of the M&A transaction. The studies showed that any gains over the short term were not significant and not abnormal as from what would normally be expected. These local research findings are congruent with the findings of studies conducted in foreign jurisdictions and are a well-documented phenomenon. The results also provide valuable arguments against the conventional suggested reasons for M&A activity.

The questions which may be put are: Why is this a Corporate Governance issue? If shareholder value is eventually created, why is this controversial? To answer the first question regard must be had to the purpose of corporate governance being to supplement enacted corporate legislation, improve leadership, increase corporate citizenry, and to improve accountability and transparency.[231] Another definition of corporate governance in the U.S. context is the ‘collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of the shareholders and stakeholders’.[232] The issue identified in this dissertation exposes a weakness in the corporate governance structure in that through M&A activity directors may receive a three-fold benefit, which answers the second question. The first benefit being an increase in salary as a result of the increase in size of the company. The second being short term benefits from increased performance of the company which it is submitted cannot be attributed to the actions or performance of a director but flow as a natural

[230] Paul Guest (2007), Sourafel Girma *et al* (2002).
[231] The Institute of Directors of Southern Africa – The Report (2009)
[232] David Larcker *et al* (2011).

consequence of M&A, and consequently a director should not be rewarded for any improved performance related to M&A. And, thirdly, the director will be rewarded through long term incentive schemes once the share price of the company rises after the estimated three year period. This is in stark contrast to the shareholder only benefiting after an estimated period of three years later by gaining an increase in dividend. If the purpose of corporate governance is to prevent self-interested conduct and protect shareholders from such conduct, it certainly fails in this regard. The Practice Notes of the King Code do warm Remuneration Committees to consider the impact of merger *announcements* on the share prices when rewarding directors.[233] This illustrates that the drafters of the Code are cognizant of the fact that M&A announcements have an impact on share prices, but have failed to consider the long term impacts after the completion of an M&A transaction.

The only statutory disclosure requirements in South African law is provided in section 30(4)-(6) of the Companies Act.[234] These sections define remuneration and state what

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[233] The Institute of Directors of Southern Africa – The Practice Notes (2012) Practice Recommendation 166.1

[234] Section 30(4) The annual financial statements of each company that is required in terms of this Act to have its annual financial statements audited, must include particulars showing-
(a) the remuneration, as defined in subsection (6), and benefits received by each director, or individual holding any prescribed office in the company;
(b) the amount of-(i) any pensions paid by the company to or receivable by current or past directors or individuals who hold or have held any prescribed office in the company;
(ii) any amount paid or payable by the company to a pension scheme with respect to current or past directors or individuals who hold or have held any prescribed office in the company;
(c) the amount of any compensation paid in respect of loss of office to current or past directors or individuals who hold or have held any prescribed office in the company;
(d) the number and class of any securities issued to a director or person holding any prescribed office in the company, or to any person related to any of them, and the consideration received by the company for those securities; and
(e) details of service contracts of current directors and individuals who hold any prescribed office in the company.
(5) The information to be disclosed under subsection (4) must satisfy the prescribed standards, and must show the amount of any remuneration or benefits paid to or receivable by persons in respect of-
(a) services rendered as directors or prescribed officers of the company; or
(b) services rendered while being directors or prescribed officers of the company-
(i) as directors or prescribed officers of any other company within the same group of companies; or
(ii) otherwise in connection with the carrying on of the affairs of the company or any other company within the same group of companies.
(6) For the purposes of subsections (4) and (5), remuneration" includes-
(a) fees paid to directors for services rendered by them to or on behalf of the company, including any amount paid to a person in respect of the person's accepting the office of director;
(b) salary, bonuses and performance-related payments;
(c) expense allowances, to the extent that the director is not required to account for the allowance;

needs to be disclosed, of relevance being bonuses and performance-related payments. As statutory compliance with disclosure provisions would be relatively simple, they were of necessity supplemented and expanded upon by the King Code as the statutory provisions provided no guidance as to how to determine the remuneration, or how disclosure is to be made. The recommendations of King Code assisted a great deal in guiding the determination, consideration, and disclosure of director remuneration, however, at the core they remain merely recommendations. As the King Code is based on the voluntary 'apply or explain' approach, and the Code makes a clear distinction between statutory provisions which 'must' be applied and those that 'should' or 'may' be applied,[235] the directors can choose not to apply a principle if they believe it to be in the best interests of the company but they must explain why.[236] All of the provisions, but for those provisions of section 30(4)-(6) of the Companies Act, relating to Remuneration Committees and the disclosure of remuneration information fall into this 'should' category and can consequently theoretically be ignored. The fact that 24% of all companies listed on the JSE chose not to apply the recommendations of the King Code[237] is evidence that the system is not as effective as it may purport to be. This fact should be a cause concern as ineffective remuneration systems have been described as a key factor and cause of the global financial crisis by the OECD[238] and UNCTAD.[239]

(d) contributions paid under any pension scheme not otherwise required to be disclosed in terms of subsection (4)(b);
(e) the value of any option or right given directly or indirectly to a director, past director or future director, or person related to any of them, as contemplated in section 42;
(f) financial assistance to a director, past director or future director, or person related to any of them, for the subscription of options or securities, or the purchase of securities, as contemplated in section 44; and
[Para. (f) substituted by s. 20 of Act 3/2011]
(g) with respect to any loan or other financial assistance by the company to a director, past director or future director, or a person related to any of them, or any loan made by a third party to any such person, as contemplated in section 45, if the company is a guarantor of that loan, the value of-(i) any interest deferred, waived or forgiven; or
(ii) the difference in value between-
(aa) the interest that would reasonably be charged in comparable circumstances at fair market rates in an arm's length transaction; and
(bb) the interest actually charged to the borrower, if less.

[235] The Institute of Directors of Southern Africa – The Report (2009) page 5.

[236] The Institute of Directors of Southern Africa – The Report (2009) page 5.

[237] Cloete Jansen van Vuuren & Jess Schulschenk *Perceptions and Practice of King III in South African Companies* (2013) Institute of Directors of Southern Africa & Albert Luthuli Centre for Responsible Leadership, University of Pretoria. Page 4.

[238] Adrian Blundell-Wignall (2008)

And, secondly, given the large benefits directors receive at the expense of shareholders, the fact that it need not be disclosed is clearly not in the interests of shareholders and should be disclosed to shareholders. The fact that such non-disclosure cannot possibly be determined to be in the best interests of the shareholders would render any 'explanation' insufficient and could be contrary to Section 76(3)(b) of the Companies Act and the director's common law fiduciary duty towards the company.

Having identified the problem and areas of concern, what follows are recommendations as can be found in recent international best practice.

International trends indicate that the larger economies such as the United States, the United Kingdom, France, Germany, and Canada have opted for mandatory statutory provisions regarding remuneration committees and specifically disclosure. The United Kingdom was the most recent to follow in instituting statutory disclosure requirements in the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 which came into effect on 1 October 2013.[240] Although these requirements, amoung others, are statutory, the UK Corporate Governance Code is applied on a voluntary 'comply or explain' basis. The King Committee argued that even though the US codified the majority of its governance code,[241] this forced compliance failed to prevent the precipitation of the financial crisis, costs too much, and the 'one size fits all' approach is not suitable.[242] The hybrid system of the UK, on the other hand, provides a good balance between forcing compliance and allowing the system to develop in a rapid enough fashion to cater for the changing commerce and governance landscape. Although this is true also in the South African context with protracted legislative processes, it is necessary to codify some aspects of the King Code as has been done in the current Companies Act with regards to King I and King II. This necessity is illustrated by the fact that 24% of companies listed on the JSE do not

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239 United Nations Conference on Trade and Development *Corporate Governance in Wake of the Financial Crisis: Selected Internal Views* (2010) United Nations Publication.
240 The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 No. 1981 of 2013
241 Institute of Directors in Southern Africa – The Report (2009) page 3.
242 Institute of Directors in Southern Africa – The Report (2009) page 3.

comply with any of the King Code recommendations.[243] The fact that director remuneration is such a contentious issue,[244] the benefits which could be earned by directors, coupled with large percentage of non-compliance, some compulsory remuneration and disclosure requirements would be prudent.

The King Code requires that only a 'majority' of the members sitting on a remuneration committee should be independent, however other jurisdictions such as the US and UK prefer to have fully independent remuneration committees.[245] This increases the independence of the committee and also allows for more objective reviews of annual remuneration packages. Another international trend is that shareholders should have a binding vote or at least an increased 'say on pay' as is illustrated by the UK's[246] 2013 Enterprise and Regulatory Reform Act which requires a binding shareholder vote for the remuneration policy and even creates a civil offence and statutory claim against a company for payments made contrary to the remuneration policy.[247] Such amendments in South Africa would greatly increase the role that shareholders play as they have minimal non-binding vote to approve a Remuneration Report, which *could* not be created by a possibly non-existent remuneration committee, with no consequence. Such provisions should obviously be geared towards the South African business context.

Certain alterations could be made regarding the approach to M&A, additional provision of information and disclosure in the King Code. For M&A, the Companies Act[248] requires approval by a special resolution at a meeting called for that purpose[249] at which meeting shareholders are provided with a copy of the Merger Agreement.[250] The contents of the Merger Agreement are dealt with fully in Section 113(2) of the Act and includes information relating to the terms and means of effecting the merger. The Practice Note on Fundamental and Affected Transactions[251] only deals with the conduct of directors

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[243] CJ van Vuuren (2013) page 4.
[244] Dr. F Theunissen (2010) page 2.
[245] D Larker (2011) page 39.
[246] Enterprise and Regulatory Reform Act 2013 – Part 6
[247] Enterprise and Regulatory Reform Act 2013 – Part 6 S226B – S226E
[248] Companies Act 2008 – section 113(5) and 115.
[249] Companies Act 2008 – section 115(2)(a)
[250] Companies Act 2008 – section 113(5)(a)
[251] King Committee, *King III Practice Notes: Introduction & Background to Fundamental and Affected Transaction* (2009)

regarding conflicts of interest and conduct of offeree companies. The only other reference the Code *et al* makes to M&A are in the Practice Notes on Remuneration in Practice Note 166.1 as stated above. The Committee should supplement the information in the Code regarding M&A and should contain the following recommendations to be implemented by companies: firstly, that in addition to the information presented in the Merger Agreement, the Risk Committee (if the company has one) or alternatively the Board should prepare an estimate as to when expected positive returns on shares will be expected, in light of research findings as elucidated above regarding the differing periods of return. Secondly, a statement of an analysis of the company classifying it into one of three types of firms which enter into M&A, namely Value, Neutral, or Glamour firms. These classifications were dealt with in the chapter on event studies, where Value firms have high book-to-market ratios and Glamour firms have low book-to-market ratios and the former generating earlier returns. Given such information, it is submitted that the Special Resolutions required to enter into M&A will be more difficult to attain. This would have a trickle-down effect and have an impact on other facets such as the annual review of the remuneration policy. It is submitted that if shareholders were granted a binding vote in determining the remuneration policy in light of the information disclosed with regards to M&A, the determination of short and long term incentives would be subject to a great deal more scrutiny in the eyes of the shareholder.

Finally, when companies enter into M&A, this should be specifically addressed at the annual review of the Remuneration Policy. Information which should be disclosed to shareholders should include the expected increase in salary of the directors (if any) on account of the increase in size, the increase in output, sales, and economies of scale and any factors of relevance which could be related to short or long term incentives. This should be viewed in light of the actual performance of the directors against the consequences which flow naturally from M&A. This information should be readily available if a thorough due diligence was performed. The link between the M&A and the short and long term performance indicators should be illustrated so as to allow shareholders to consider and vote on the gains which may accrue to directors in light of their own shareholder return.

It is the submission of this dissertation that the corporate governance structures as they stand do not allow for the above information to come to light. As a consequence, shareholders, especially institutional investors, cannot exercise their control over directors effectively and are prejudiced by the *status quo* whereas directors benefit excessively. It is evident from international trends that disclosure is becoming more mandatory and that certain aspects of corporate governance are being made peremptory as opposed to voluntary and South Africa should follow suit sooner rather than later.

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